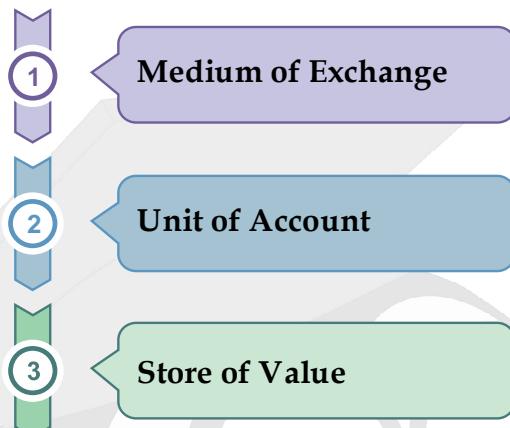


12. International Monetary System

What is money?

- A current medium of exchange in the form of coins and banknotes; coins and banknotes collectively
- Any good that is widely accepted in exchange of goods and services, as well as payment of debts.

Three functions of money :



1. **Medium of Exchange** : money used for buying and selling goods and services
2. **Unit of Account** : common standard for measuring relative worth of goods and services
3. **Store of Value** : convenient way to store wealth

International Monetary System

- *International monetary systems are sets of internationally agreed rules, conventions and supporting institutions, that facilitate international trade, cross border investment and generally there allocation of capital between nation states.*
- *International monetary system refers to the system prevailing in world foreign exchange markets through which international trade and capital movement are financed and exchange rates are determined.*

Features that IMS should Possess

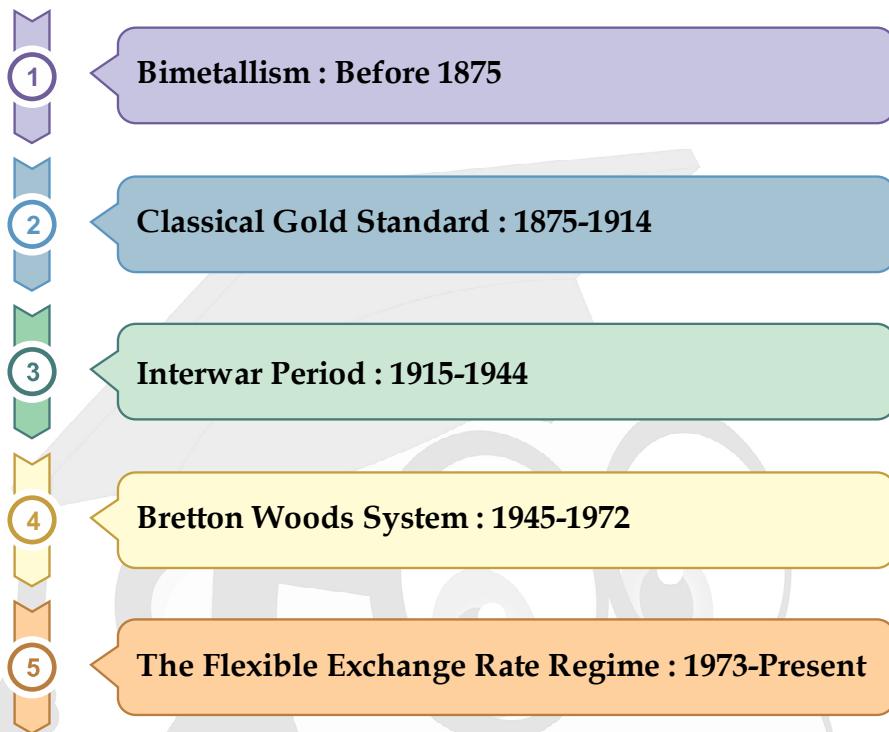
- Efficient and unrestricted flow of international trade and investment.
- Stability in foreign exchange aspects.
- Promoting Balance of Payments adjustments to prevent disruptions associated.
- Providing countries with sufficient liquidity to finance temporary balance of payments deficits.
- Should at least try avoid adding further uncertainty.
- Allowing member countries to pursue independent monetary and fiscal policies.

Requirements of Good International Monetary System

- **Adjustment** : a good system must be able to adjust imbalances in balance of payments quickly and at a relatively lower cost;

- **Stability and Confidence** : the system must be able to keep exchange rates relatively fixed and people must have confidence in the stability of the system;
- **Liquidity** : the system must be able to provide enough reserve assets for a nation to correct its balance of payments deficits without making the nation run into deflation or inflation.

Stages in International Monetary System



Bimetallism: Before 1875

- A “double standard” in the sense that both gold and silver were used as money.
- Some countries were on the gold standard, some on the silver standard, some on both.
- Both gold and silver were used as international means of payment and the exchange rates among currencies were determined by either their gold or silver contents.
- **Gresham's Law** implied that it would be the least metal that would tend to circulate.

Gresham's Law

Gresham's law is an economic principle that states:

“If coins containing metal of different value have the same value as legal tender, the coins composed of the cheaper metal will be used for payment, while those made of more expensive metal will be hoarded/exported and thus tend to disappear from circulation.”

It is commonly stated as : **“Bad” (abundant) money drives out “Good” (scarce) money”**

The law was named in 1860 by Henry Dunning Macleod, after Sir Thomas Gresham (1519-1579), who was an English financier during the Tudor dynasty. However, there are numerous predecessors.

The law had been stated earlier by Nicolaus Copernicus; for this reason, it is occasionally known the **Copernicus Law**.

Gold Standard

During this period in most major countries:

- Gold alone was assured of unrestricted coinage
- There was two-way convertibility between gold and national currencies at a stable ratio.
- Gold could be freely exported or imported.

The exchange rate between two country's currencies would be determined by their relative gold contents.

Rules of the system

- Each country defined the value of its currency in terms of gold.
- Exchange rate between any two currencies was calculated as X currency per ounce of gold/ Y currency per ounce of gold.
- These exchange rates were set by arbitrage depending on the transportation costs of gold.
- Central banks are restricted in not being able to issue more currency than gold reserves.

Classical Gold Standard : Exchange rate determination

For example, if the dollar is pegged to gold at U.S.\$30 = 1 ounce of gold, and the British pound is pegged to gold at £6 = 1 ounce of gold, it must be the case that the exchange rate is determined by the relative gold contents

$$\$30 = £6$$

$$\$5 = £1$$

Classical Gold Standard

- Highly stable exchange rates under the classical gold standard provided an environment that was favorable to international trade and investment
- Misalignment of exchange rates and international imbalances of payment were automatically corrected by the *price-specie-flow mechanism*.

Price-Specie-Flow Mechanism

Suppose Great Britain exported more than France imported from Great Britain.

- Net export of goods from Great Britain to France will be accompanied by a net flow of gold from France to Great Britain.
- This flow of gold will lead to a lower price level in France and, at the same time, a higher price level in Britain.

The resultant change in relative price levels will slow exports from Great Britain and encourage exports from France.

Arguments in Favor of a Gold Standard

- Price Stability.
- By tying the money supply to the supply of gold, central banks are unable to expand the money supply.
- Facilitates BOP adjustment automatically
- price-specie-flow mechanism

Arguments against Gold Standard

- The growth of output and the growth of gold supplies are closely linked.
- Volatility in the supply of gold could cause adverse shocks to the economy,
- In practice monetary authorities may not be forced to strictly tie their hands in limiting the creation of money.
- Countries with respectable monetary policy makers cannot use monetary policy to fight domestic issues like unemployment.

Interwar Period: 1915-1944

- Exchange rates fluctuated as countries widely used “predatory” depreciations of their currencies as a means of gaining advantage in the world export market.
- Attempts were made to restore the gold standard, but participants lacked the political will to “follow the rules of the game”
- The world economy characterized by tremendous instability and eventually economic breakdown, what is known as the **Great Depression (1930 - 39)**.

Interwar Period: 1915-1944

International Economic Disintegration

- Many countries suffered during the Great Depression.
- Major economic harm was done by restrictions on international trade and payments.
- These beggar-thy-neighbor policies provoked foreign retaliation and led to the disintegration of the world economy.
- All countries' situations could have been bettered through international cooperation
- **Bretton Woods agreement**

Bretton Woods System: 1945-1972

- *Named for a 1944 meeting of 44 nations at Bretton Woods, New Hampshire.*
- *The purpose was to design a postwar international monetary system.*
- *The goal was exchange rate stability without the gold standard.*

Resulted in ;

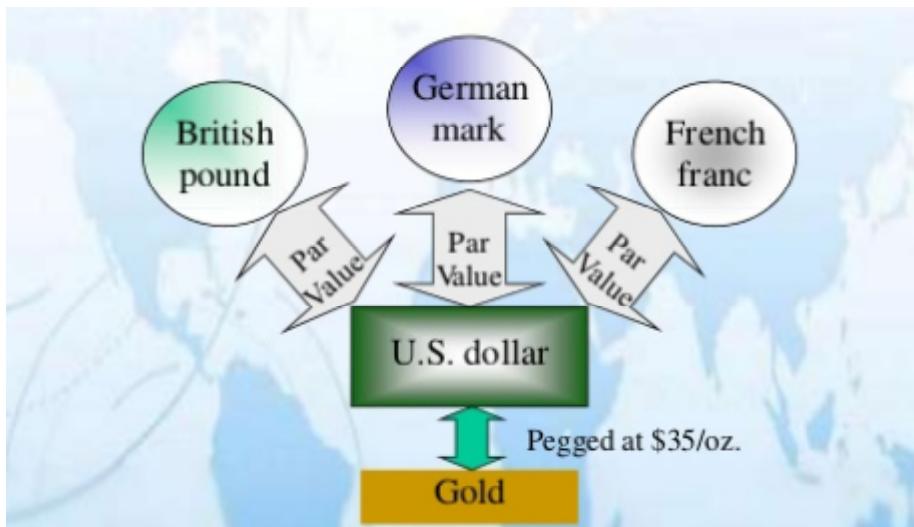
The result was the creation of the IMF and the World Bank

1. **IMF** : maintain order in monetary system
2. **World Bank** : promote general economic development

Features of Bretton Woods System

- Under the Bretton Woods system, the U.S. dollar was pegged to gold at \$35 per ounce and other currencies were pegged to the U.S. dollar.
- Each country was responsible for maintaining its exchange rate fixed : within $\pm 1\%$ of the adopted par value by buying or selling foreign reserves as necessary.
- The Bretton Woods system was a dollar-based gold exchange & standard.

Bretton Woods System: 1945-1972 Par value / pegged exchange rate system



The Demise of the Bretton Woods System

- In the early post-war period, **the U.S. government had to provide dollar reserves to all countries who wanted** to intervene in their currency markets.
- The increasing supply of dollars worldwide, made available through programs like the Marshall Plan, meant that the credibility of the gold backing of the dollar was in question.
- U.S. dollars held abroad grew rapidly and this represented a claim on U.S. gold stocks and cast some doubt on the U.S.'s ability to convert dollars into gold upon request.

The Demise of the Bretton Woods System

- Domestic U.S. policies, such as the growing expenditure associated with Vietnam resulted in more printing of dollars to finance expenditure and forced foreign governments to run up holdings of dollar reserves.
- *The dollar was overvalued in the 1960s.*
- *In 1971, the U.S. government "closed the gold window" by decree of President Nixon.*

The Demise of the Bretton Woods System

- The world moved from a gold standard to a dollar standard from Bretton Woods to the **Smithsonian Agreement**. Growing increase in the amount of dollars printed further eroded faith in the system and the dollars role as a reserve currency.
- By 1973, the world had moved to search for a new financial system: one that no longer relied on a worldwide system of pegged exchange rates.

Smithsonian Agreement

An agreement reached by a group of 10 countries (G10) in 1971 that effectively ended the fixed exchange rate system established under the Bretton Woods Agreement.

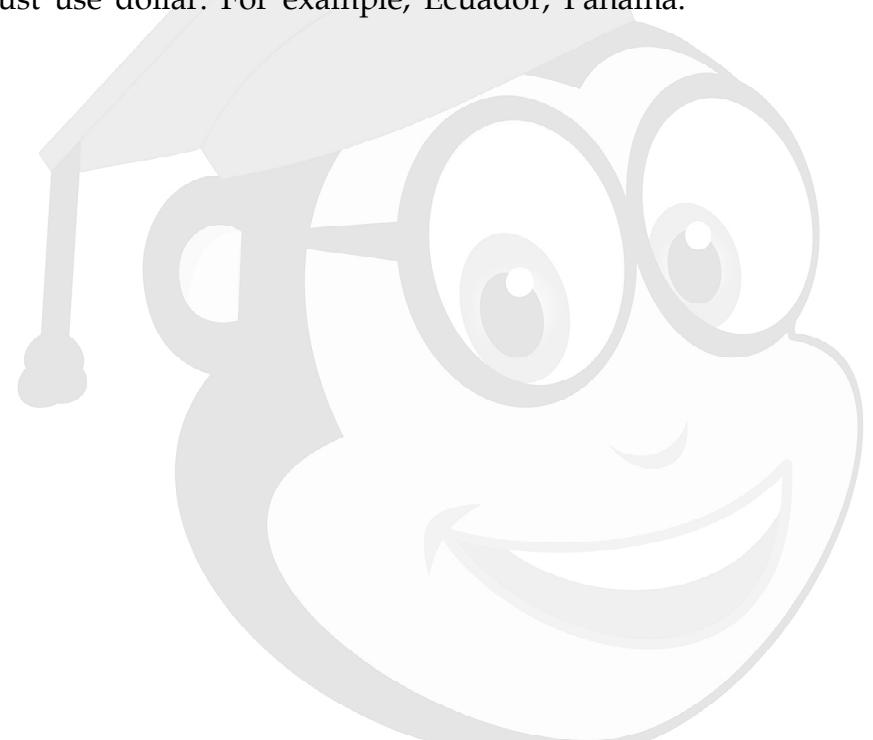
The Smithsonian Agreement reestablished an international system of fixed exchange rates without the backing of silver or gold, and allowed for the devaluation of the U.S. dollar. This agreement was the first time in which currency exchange rates were negotiated.

The Flexible Exchange Rate Regime

- Flexible exchange rates were declared acceptable to the IMF members.
- Central banks were allowed to intervene in the exchange rate markets to iron out unwarranted volatilities.
- Gold was abandoned as an international reserve asset.
- The currencies are no longer backed by gold

Current Exchange Rate Arrangements

- **Free Float** : The largest number of countries, about 48, allow market forces to determine their currency's value.
- **Managed Float** : About 25 countries combine government intervention with market forces to set exchange rates.
- **Pegged to Another Currency** : Such as the U.S. dollar or euro etc..
- **No National Currency** : Some countries do not bother printing their own. They just use dollar. For example, Ecuador, Panama.



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